SHORT BRIEFINGS ON LONG TERM THINKING – EPISODE 33

The power of actual investing during changing times

MB – Malcolm Borthwick

SD – Stuart Dunbar

MB: Hello and welcome to *Short Briefings on Long Term Thinking*. Thanks for joining us. I'm Malcolm Borthwick, managing editor at Baillie Gifford.

In the ever-changing world of investment management, the past five years have been a roller coaster. There's been Covid, advances in artificial intelligence and an end to low interest rates. It’s been a transformative period. It's also been five years since our partner Stuart Dunbar, published his provocative paper, *Let's talk about actual investing*. In it, he urged the investment industry to focus on allocating capital to companies rather than fixating on share prices, arguing that it's visionary entrepreneurs and company leaders that generate profits, not stock markets, and that in the long term, this approach was far more likely to create value for society than abstract concepts and short-term speculation.

So, with so much having transpired since, does Stuart still stand by the thesis? Well, we'll find out in a moment. But first, a quick reminder that as with all investments, your capital is at risk and your income is not guaranteed.

Stuart, great to have you back on *Short Briefings on Long Term Thinking*.

SD: Thank you, Malcolm. It's very hard to believe it's been five years. Great to be back.

So, at the heart of this thesis of actual investing, it seems to be about companies and capital allocation. This seems quite a basic concept. Or am I missing something?

It is a basic concept, and I think it's one that doesn't really change since we last did this. What's changed? I think the answer is everything and nothing. Nobody could have observed the pattern of stock market returns in the last three or four years, certainly post-jury and post-Covid, and not come to the conclusion ‘what on earth is going on here?’

Do we need to start worrying much more about how markets behave rather than how companies behave? And I actually think that this is where it's very valuable to step back and say there are some things we just can't control. What have we really learned in respect of growth companies? What we've learned is the market can get very, very over-excited and then very, very gloomy.

And the difference in prices between great excitement and great gloominess is really very dramatic. What are we supposed to do with that? I think this is the point of 'nothing's changed'. We can't predict how that's going to work out. I mean, if the last three years have shown us anything it's that these swings of emotion can get even more extreme than we thought we could.

What can we do? We can keep on focusing on companies. We can keep on focusing on opportunity, and we can keep on looking how we're allocating capital in the real world. So that bit hasn't changed at all. But, you know, I don't think it would be unreasonable to say that we haven't been scratching our heads and wondering if the last few years of anything.

MB: So your core thesis remains the same?

SD: Absolutely the same. I mean, I think it has to be the same. There are active investors out there, and we spoke about this five years ago, who may have skills in market timing, who may be able to anticipate what other investors are going to do and therefore what the market is going to do. I think there are very few people that can do that.

It's very hard to do it consistently and even those that do eventually pretty much, I think all of them have got it wrong eventually. I'm not saying it's an easy job, but it's a far, far more doable task to actually try and understand companies and the opportunities they have and the direction of travel they're going.

MB: And you talk about the wider market there, is a purpose of actual investing to focus on Baillie Gifford's purpose and our approach, or is it to influence the wider industry?

SD: Yeah, I mean, our job is to deliver for our clients. You know, we're not actually here to make the world a better place. I mean, that would be a nice thing if we could do that along the way. But first and foremost has got to be 'let's find these companies that we think are potentially great'. Let's understand, let's explain to clients how we're going to go about doing that so that they don't all get spooked. I mean, one of the big challenges that an investment approach such as ours, a long-term investment approach, has, if the clients don't fully understand the nature of it, they will trade in and out of funds or allocate to and from us in a way that can be quite damaging for them. Typically buying at the top and selling at the bottom. So, let's focus on that. We're still trying to do that for clients.

MB: What's interesting internally, I certainly found since joining Baillie Gifford, is I feel we encourage very much an independence of thought and federal thinking. Our strategy is to think differently and be entrepreneurial within that environment. Is it possible to have this overarching actual investing philosophy?

SD: Yes. So, I'll answer that from two different directions. One is when we alighted on this notion that we should call ourselves actual investors, it wasn't just some made up thing that I came up with. It was a reflection of many discussions about what are the common beliefs that we want people to follow in our firm. And so that is long-termism and conviction and patience and alternative sources of information and a focus on real world capital allocation.

So, I think we can apply all of those characterisations to what all of our investment teams do. But then you have the value of autonomy, which is they don't all have the same strategies. In the main we’re an equity growth house, but there are more and less aggressive forms of pushing that growth task. But we also have multi-asset and income strategies that have different objectives.

The common factors are still there, but the way that the individual investment teams apply that needs to be suitable to their own philosophy and their own strategies. The different strategies that we offer are often quite different from each other, but I think these overriding principles of actual investing actually can apply across the whole firm, and we do hold ourselves reasonably accountable to our activities.

It's quite useful to be able to check back and you know, of course we are, but are we investing with conviction? Are we being long term, are we ignoring short term share price moves? And yes, we are. But it's quite it's quite useful to have that sort of a checklist to hold ourselves accountable against, I think.

MB: I mean, Baillie Gifford is unequivocally a growth investor, but what's interesting is looking back at portfolios 15 years ago, a lot of listeners might be surprised to know that the likes of Petrobras, Nokia and these type of companies like Vodafone were in the portfolio. Why is that? And what's changed?

SD: That's where we thought the growth was coming from back then. I mean, that's a really interesting question because it raises in hindsight, did we have the right companies? Did we identify where growth was going to come from on a five, ten, year view or whatever? And in some cases, we'll have got that right.

In those days, we weren't thinking about the death of fossil fuels, and oil and gas not coming out of the ground, and stranded assets. I mean, maybe some people were thinking about it 15 years ago, but not really. So, it's the same task then as it was now. Where do we see blue sky sustained growth coming from? We thought those were the right firms.

I mean, I think Nokia, certainly towards the end, Nokia was a disaster, of course. Why did we think Nokia was a great firm? Because we hadn't at that stage worked out that they were going to be completely overtaken technologically. And Apple comes along, and Samsung, and they all come along and kill Nokia. And actually, maybe the interesting lesson there is it's a new technology that comes along and blows the incumbents out the water.

And, actually, that's an interesting thing. I think we've become better, certainly in the last ten years or so, trying to anticipate what could completely come along and destroy some quite large companies who, you know, get completely displaced.

So, if you go back, we probably did speak five years ago about Netflix, or something like that. But there's an example of an industry that's been turned on its head and some of the incumbents have done quite well out of it, but many new firms have popped up. So that's a long way, Malcolm, of saying it's funny how the portfolios change more than you think.

MB: Baillie Gifford often gets labelled as a tech investor. Is that fair?

SD: I think we have to be very clear that we don't. People talk about us as technology investors. We're not technology investors, we're investors in companies that are harnessing technology to create some sort of competitive edge or new business model or indeed an entirely new product. I think it's very important to make that distinction. Technology is just something the companies have to harness to be successful.

MB: You mentioned Netflix earlier, Amazon. Are these still the companies that will drive growth in the future?

SD: I think to a lesser extent, we're still fans of both of those companies. You might argue that Amazon is now so big that it's just hard to believe that it can continue to grow in the way that it has been, although I think there's huge potential in both Amazon and Netflix for them to start to focus more on cash flow generation rather than reinvesting for growth.

That probably makes them less interesting to us. But what happens with these companies, and it's happened with the likes of Alphabet and Meta, is they just become huge cash generation machines. They're still hugely successful companies. They become of interest a different type of investor, arguably.

I suspect the next ten years of growth is going to come from different places. The last 10 or 15 years, maybe has been a very unusual set of circumstances in which you have a sort of coincidence of digitalisation in the broadest sense and incredibly cheap capital.

So, you've got companies that don't need a lot of capital. It’s very cheap anyway. And in digital type platform businesses, you can roll out globally at very low cost. So, this has created these truly remarkable businesses that have very quickly grew up to be these cash generation machines. That may have been almost a one-off set of circumstances.

The new things that are happening now, the technologies that are required to change the world, things like electric vehicles and battery manufacturing and new approaches to healthcare, which are the things that are most interesting us now, those are quite capital intensive. So, I think we'll see the growth coming from different places. But the more important thing is it's also a different type of growth.

You know, you can't build battery gigafactories all over the world without raising a whole lot of capital to do it. Those can still be very successful businesses. But I think the nature and duration and patience, actually, that growth investors are going to need… I don't think we're going to see many really large-scale businesses throwing off cash within three years of being launched.

I think we're into this kind of much longer duration now and for us, that's potentially an opportunity, you know, because our starting point here is, it’s okay, if it takes five years. We love companies that are investing heavily. As long as there's a path to decent margins and profitability.

MB: And give me an example of those areas that might excel and succeed over the next ten years.

SD: So, I talked about batteries but is much wider than that. Essentially, we need to completely replace our energy system, or the electricity system. We need to make many more things electric. And we're very interested in things like very high-end cables, which bring the electricity from offshore wind turbines on land where it's actually useful.

Once you've laid the cable under the sea, you really don't want to be having to fix it. So, it's a premium product and there's only a couple of providers out there that are really able to do that. The point I'm making is the energy transition is not just via solar panel manufacturers. There are the technology companies that are improving yields from solar panels, there are the cable manufacturers. There's even AI type software companies that will be required to help a smart grid work.

So if you've got multiple, I mean thousands and thousands, of sources of generation of electricity, you have this complex grid network. It's not sort of one-way pipe any more from a power station to your house, it's incredibly complex to manage all of that. There are companies that are positioning themselves to do that.

So I think there's lots there. It's really exciting. The other one that's super exciting is health. We've got this aging problem, demographic problem, where health care systems are already vastly expensive and it's just getting worse and worse as there are fewer and fewer young people and more and more older people.

Traditional forms of health care are becoming more and more expensive. Something has to give at some point. Now what do we do? We don't sort of start neglecting old people. We find far more cost-effective ways of dealing with this challenge. What's coming down the line there I think is fascinating. We're very early - so this is your world of gene sequencing and gene manipulation, again, artificial intelligence.

It's technologies like - so everyone knows about Moderna now. We invested in Moderna before anyone had heard of Moderna. And it's not a Covid company. We didn't invest in it because we had some crystal ball and saw the pandemic coming. We invested in it because they have a fabulous platform in which they can effectively tell your body to program itself, to either vaccinate you or treat you against forms of cancer and forms of viruses and whatever else.

So, they are one example of that. But there are many more companies in that area that are pioneering completely different and far more affordable ways to tackle our health problems.

MB: It's really interesting because in the here and now, it's very easy to underestimate the sheer rate and scale of progress we're seeing in health innovation. It's phenomenal, isn't it?

SD: Yeah, it’s something we’re particularly interested in, how technologies come together to create opportunity. So, this is all becoming possible because gene sequencing has dropped by a factor of 100,000 or something in the last ten years. It's now essentially affordable. But what you get out of sequencing a whole lot of genes, a small population of gene sequencing creates mind boggling amounts of data, which we wouldn't have been able to do very much with even six or seven years ago.

But now we can harness the processing power that comes ultimately from ASML’s ability to make better and better machines that make chips. Samsung makes them or TSMC makes them. They then go into ever more powerful computers. We throw AI at computers, we put the genetic data set into the AI machine, and you actually start to identify some patterns which allow us to direct how we try and treat disease.

And then we've got the ability to somewhat manipulate genes and so we can actually use that information to directly treat very specific conditions or indeed widespread conditions of the likes of Covid-19. So, it's all ‘how do you how do technologies come together?’

MB: What has undoubtedly changed over the last five years is higher interest rates. And that seems bad news for growth investors.

SD: It's fair to say that, as a general point, higher interest rates and inflation are unhelpful for growth investors. What people are not fully thinking about is, as ever, it's about the individual companies. What's harder for companies now? If they're not well funded, it's harder to get funding, particularly as we speak. It's harder to get capital, it's more expensive when you do get it. If economic growth in general is slower, maybe it takes longer for a young company to get to profitability.

So, let's not pretend nothing has changed. We've been spending a lot of time looking at how much cash have early-stage companies got. Are they able to get through to profitability, if not, have they got secure funding?

There's lots of companies that are not profitable but are cash flow generative. And that's often a good thing because that means they're reinvesting their free cash flow for future growth. But the changed environment makes all of that stuff matter more. You can't be a great company if you fail in the meantime.

I think we've looked very hard at that. That's been something we spent a lot of time on in recent years. But the good news is most of the companies that we favour scored pretty well on that. Our portfolios are far less indebted and have better cash flow than your average growth companies do. And then there's also on the inflationary side, you don't have to worry too much about inflation if you have companies that are competitive and providing real value to their customers versus the alternatives and therefore have pricing power.

So, this idea is that everyone knows you discount at a higher rate, so your net present value is lower in a high inflation environment. That doesn't take into account the fact there are some companies that just offset that by raising their prices and they can because they're providing better value for money in whatever sector it is than their competitors are doing.

And one of my colleagues said something which made me pick up my ears recently, along the lines of ‘share prices can't go up faster than the value added a company is offering to its customers’. But what that boils down to is, if you're providing real value, your customers will stick with you. You will have some pricing power.

And in the long run, you know, as we always say, the share price eventually reflects the value add that your customers are getting because that's what they're willing to pay.

MB: So, do you think it's over played in terms of that link between interest rates and growth investing? And if so, why do you think it has been so challenging for growth investors over the last couple of years?

SD: I think, yes, it's overplayed. If you look at the 50s, 60s, 70s, 80s, even the 90s, I don't think you'll find anything like what people now think is a robust inverse relationship between inflation, interest rates and growth companies. It’s a relatively recent phenomenon and it might be to do with, as we were talking earlier about, really cheap money in special circumstances.

So, we're now in a position where people almost unthinkingly, in my view, respond as if inflation and interest rates are unexpectedly high, or higher than previous expectations, then growth stocks get sold off, and to a lesser extent, the inverse. It comes back to this point that not all growth is equal. I mean, it really isn't.

In fact, I mean, I would make the argument that in the coming few years, companies that have grown by borrowing, not being profitable or even having a road to profitability, by grabbing market share rather than trying to build a decent business, I think in coming years we will see a big shake out.

I think what we will see is that good companies that haven’t just been existing on cheap borrowed money, their earnings growth will come through. They're still great companies. There are always great companies. As the earnings come through, you don't need a re-rating in the share prices. You just need a sort of better understanding of these companies that are actually going to come out pretty strongly.

You know, we obviously think we're reasonably good at picking the right ones. Time will tell.

MB: You're very close to investors, Stuart. Give the listeners an idea of what's been going on behind the scenes at Baillie Gifford over the last couple of years in terms of looking at portfolios and stress-testing them.

SD: Yeah, you know, we've looked back at if we should have done more at the beginning of 2021 to lock in what was a sort of crazy performance in 2020. And the answer on the whole is no. I mean, obviously we make mistakes and often those mistakes come in the form of companies that had great opportunities but executed badly. So was that our mistake? Is it the company's mistake? .

I think it's a bit of both, right. I mean, we should have been able to identify when they're not executing well. So, there's been a bit of that. There has been this need to go back through the portfolios in great detail. So, we can see in this new funding environment, interest rate, environment, inflationary environment, are we still satisfied that these companies have pricing power and cash flow strength and the mean they have, because there's a sort of characteristics we look for.

There have been some where we've come to the view and said, look, you know, this is problematic. Even if this is potentially a good company, it's hard to see the runway to profitability now. So, in those cases, we have reduced some holdings. But could we have, I mean, if I had a crystal ball we would have sold everything at the end of 2020 and bought it back now.

But we can't do that. And I don't think anyone can do that. So, you've got to question whether you should have acted differently, but you also have to carefully understand whether you're imposing hindsight on a decision that you just couldn't have made at the time. To try and get under the hood of what investors have been doing, it's a lot of that, could we have done anything differently?

No, we don't think we could. Do we still have companies that we think are great and in the main, yes, we do. Are we complacent? I mean, funnily enough, I have said to some of our investors who, and they don't mean to be glib, they just say, 'well, we've got five year horizon, so don't measure us over the last three years.'

You know, I think we've got to go a bit further than that. You know, it's been truly extraordinary. So just wait a bit longer isn't really a sufficient answer. So, you know, we've been very strongly encouraging investors to go a bit further than that, to think a bit more deeply to satisfy themselves and their colleagues that our thesis is still valid and we haven't found any reason to question that. So, you know, on we go.

MB: I mean, thinking differently is absolutely crucial. How do we guard against whether it's static thinking or group thinking to ensure our investors and all of us continue to evolve?

SD: I think it's a behavioural question. How do you create an environment in which you can robustly challenge each other? But without negating the optimism and positivity that you need to be a successful investor. You need that. You can't invest if you're so worried about being wrong all the time. We do say, let's think about what might go right, not wrong.

And we strongly believe that. But you need to create an environment in which, if you invest that way, you need to be open to challenge. We understand this is your bull case. But what might go wrong? And so we have those discussions and the investment teams and I think it is facilitated by the nature of the firm. We are a calm and thoughtful and patient organisation, but the outward impression probably doesn't truly reflect how much internal angst we have about 'what if we're wrong?'

So that's good up to a point. You know, if it leads you to chopping and changing your portfolios, then that's going to be a terrible outcome. But never believe your own propaganda. I think that's it and we're constantly testing that.

MB: I'm going to completely change of pace now and ask you what book you're reading at the moment.

SD: Well, what I actually do read it for fun, I'm an avid devourer of *The Golfer's Journal*. It's not really about golf. It's about people. Individual journeys and relationships that are forged. If someone is going through a rough time in their life, men don't generally sit down and have heart to hearts. But you know what? A lot of it comes out on the golf course.

So, it's fascinating. That's a really weird and unexpected answer. But I find that interesting because, through a very narrow lens, it's a commentary on how people think about their lives and what brings them happiness. I recommend it.

But the two main books I'm reading at the moment, one is Michael Lewis's latest effort called *Premonition*. People will know Michael Lewis from *Flash Boys* and all of that. Ostensibly, it's about the lack of preparedness for a pandemic and obviously pre-Covid-19 and he's gone back and looked at why was there a lack of preparedness? And it's really not a book about pandemics. It's a book about the failures of large organizations to listen to experts within the bureaucracy. I think there are much wider applications. I'm finding a fascinating book about how do you make sure the right people get out at the right time?

So that's one of them. And the other one is, is *The Economics of Fund Management*. Now given that I'm a partner in an investment firm, you might think I'm reasonably *au fait* with that and I hope I am. But it's always good to test your theory, right? So, there's a guy called Ed Moisson who's written *The Economics of Fund Management*.

And I'm going through that, actually. And, in some ways, certainly for someone in the role that I have, it's largely reflective of fairly obvious things. But nonetheless, it's quite helpful to take that step back and see whether there's anything there that raised eyebrows.

MB: That's a great eclectic mix of reading there. We'll put those titles in the show notes for the podcast, so other listeners can check out those books and *The Golfers Journal* when they like. It's been great to have you on the podcast. Thanks so much for joining us on *Short Briefings on Long Term Thinking*.

SD: Thanks for having me, Malcolm. I'll see you again in another five years, maybe.

MB: And thanks for investing your time in *Short Briefings on Long Term Thinking* and you can find our podcast at bailliegifford.com/podcasts or subscribe at Apple Podcasts, Spotify or TuneIn. And if you enjoyed listening to this podcast, why not check out the first series of *Invest in Progres*s, which is Scottish Mortgage's new podcast. This includes interviews by the managers with some of the most transformational growth companies that they invest in.

It's been great to have you with us. I hope you enjoyed listening. Wherever you are in the car, at home or on the way to work, goodbye.

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